Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	

Prepared Testimony of Jeffrey Reynolds on Behalf of Independent Telephone & Telecommunications Alliance Before the Federal-State Board on Universal Service

I. Introduction and Summary

My name is Jeffrey Reynolds. I am a principal in the economic consulting firm of Parrish, Blessing & Associates, Inc. ("PBA"). PBA provides economic, financial and regulatory consulting services primarily to midsize ILECs - many of our clients are Independent Telephone & Telecommunication Alliance ("ITTA") members. Prior to joining PBA in 2001 I was employed by ALLTEL Corporation as Vice President – Wholesale Services at its headquarters in Little Rock, Arkansas. Throughout my thirty-year telecommunications career, I have worked for or with midsize ILECs, beginning with my employment with North Pittsburgh Telephone in Gibsonia, Pennsylvania in 1974.

I am testifying on behalf of the ITTA, an organization of midsize ILECs that collectively operate in more than 40 states, and provide local exchange and exchange access service to over ten million access lines. ITTA's member companies offer a broad range of services to their customers, including interexchange, Internet, broadband, video and wireless. Most ITTA member companies qualify as rural telephone companies within the meaning of Section 3(37) of the Communications Act of 1934, as amended (the "Act").[1]

---

[1] 47 U.S.C. § 153(37).

ITTA appreciates the opportunity to offer this testimony on the continuing need to provide "specific, predictable and sufficient" universal service high-cost support for rural carriers. By this testimony, ITTA urges the Joint Board to recommend that the FCC retain the definition of "rural" used to qualify for high-cost support[2] and to continue to calculate support on a study area basis. In the collective experience of ITTA members the current mechanism for determining and distributing high-cost support to rural carriers is functioning well. There is no compelling justification for the Joint Board to abandon the use of the statutory definition of "rural telephone company" as the threshold for determining eligibility for rural high-cost support. Changing eligibility criteria for universal service high-cost support – by, for example, requiring carriers to calculate average cost-per-line at a level larger than the study area level – likely would strip many rural communities of their support based simply on the fact that they are served by a carrier that is part of a larger holding company structure. Such a change would lead to impermissible implicit subsidies and would render service unaffordable in many rural areas, in violation of Sections 254(b)(3) and 254(e) of the Act.

ITTA also requests that the Joint Board recommend retaining use of embedded actual costs in calculating support levels for a given rural study area. The current system utilizing embedded costs best meets the "specific, predictable and sufficient" tenets for universal service explicit in the act. By their very nature actual costs are the most precise measure for determining support for rural ILECs. Any other approach would create serious dislocations in funding and jeopardize the goals of universal service.

[2] SureWest Communications, an ITTA member company, believes the present definition for rural treatment of high cost companies is flawed.

II. The Unique and Variable Nature of Rural Markets Justifies the Continued Use of the Term "Rural Telephone Company," as Defined in the Act, to Determine Eligibility for High-Cost Support in Rural Areas

Currently, to determine which carriers serve are eligible for high-cost support in rural areas, the FCC uses the statutory definition of "rural telephone company."[3] This multi-part definition has worked well over the last eight years to properly target high-cost support to rural communities, the characteristics of which are highly variable, but which have many aspects in common. The Joint Board should not adopt proposals to modify the eligibility criteria for rural universal service support.

Section 254(b) of the Act sets forth the principles that govern federal universal service policies. Specifically, Section 254(b) requires that support mechanisms be specific, predictable, and sufficient to preserve and advance universal service.[4] In addition, federal universal service policies must ensure that consumers in rural, insular, and high-cost areas have access to telecommunications and information services that are reasonably comparable to those services provided in urban areas, and at reasonably comparable rates.[5] FCC precedent demonstrates that the characteristics of rural areas justify treating them differently from non-rural areas.

---

[3] *Universal Service First Report and Order*, 12 FCC Rcd at 8943-44, ¶ 310. Specifically, Section 153(37) provides that:

> The term "rural telephone company" means a local exchange carrier operating entity to the extent that such entity – (A) provides common carrier service to any local exchange carrier study area that does not include either – (i) any incorporated place of 10,000 inhabitants or more, or any part thereof, based on the most recently available population statistics of the Bureau of the Census; or (ii) any territory, incorporated or unincorporated, included in an urbanized area, as defined by the Bureau of the Census as of August 10, 1993; (B) provides telephone exchange service, including exchange access, to fewer than 50,000 access lines; (C) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or (D) has less than 15 percent of its access lines in communities of more than 50,000 on the date of enactment of the Telecommunications Act of 1996.

47 U.S.C. § 153(37).

[4] 47 U.S.C. §254(b)(5).

[5] *Id.* § 254(b)(3).

A one-size-fits-all approach to the universal service fund simply will not capture the uniqueness and variability of rural markets as Congress intended. Record evidence abounds demonstrating the unique attributes of rural markets, as well as the diversity among rural markets.[6] Compared to the larger ILECs, rural carriers generally serve smaller subscriber bases which are comprised of people who live in more sparsely populated areas.[7] Rural carriers serve fewer than twelve percent of the nation's access lines in total,[8] but 38% of the nation's land area, and 93% of the study areas.[9] While the average population density for areas served by non-rural carriers was 105 people per square mile, the average population density for areas served by rural carriers is merely 13 people per square mile.[10]

Not only do the markets served by rural carriers differ significantly from non-rural markets, but wide variability exists *among* rural markets as well. The many differences even among the areas that currently receive "rural" treatment under the Act confirms that there is *no* single test (such as companies with fewer than 100,000 lines) that would accurately capture all companies that merit categorization as "rural." The number of lines served by individual rural carriers varies, and the range of their costs varies greatly. For example, among ITTA members, ALLTEL's smallest study area, ALLTEL New York – Red Jacket, has fewer than 2,800 lines, while CenturyTel's study areas range in size from tiny CenturyTel of Chester, Iowa, with 221 lines, up to CenturyTel of Washington, with approximately 180,000 lines. TDS's study

---

6 *See, e.g.*, Rural Task Force, *The Rural Difference*, White Paper #2 (Jan. 2000) ("*Rural Task Force White Paper #2*") at 50.

7 *In the Matter of Federal-State Joint Board on Universal Service*, Recommended Decision, FCC 00J-4, 16 FCC Rcd 6153 (rel. Dec. 22, 2000) ("*Rural Task Force Recommendation*") at A-11.

8 *In the Matter of Federal-State Joint Board on Universal Service*, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, 18 FCC Rcd 22559, 22559 n.1 (2003) ("*Non-Rural High Cost Modification Order*").

9 *Rural Task Force Recommendation*, 16 FCC Rcd at A-11.

10 *Id.*

areas range from just over 100 lines (Asotin Telephone Company, Oregon) to approximately 64,000 (Tennessee Telephone Company).[11] With respect to investment-related costs, wide variability exists as well. The gross investment in central office switching equipment ranges from very small amounts to as much as $9,191 per loop.[12] Loop costs also vary widely among rural carriers, with the range in expense per loop spanning between $4 and $1,585.[13] Use of the definition of "rural telephone company" under the Act captures the variability of these markets better than any single test could.

As a result of the factors described above, rural carriers require substantially more telecommunications plant to reach customers in high-cost areas than metropolitan carriers require. At the same time, average disposable income levels in rural communities are lower than in urban communities. Further accentuating the differences between rural and urban areas, in recent years, rural incomes also have not kept pace with incomes in urban areas. Thus, increases in local rates are more likely to adversely impact customers in rural areas than in urban areas.

As discussed further below, many proposals currently being considered by the Joint Board would result in many carriers and the communities they serve losing their eligibility for rural high-cost support. Considering the comprehensive reforms currently under consideration at the FCC, it is dangerous to make radical changes in the universal service rural support eligibility rules at this time. Among other things, the FCC is considering major changes to the current system of intercarrier compensation and access revenues as well as the designation of competitive eligible telecommunications carriers ("CETCs"). Any change to the rural

---

[11] *See* Universal Service Administrative Company, High Cost Loop Support Projected by State by Study Area, 2Q 2004, available at http://www.universalservice.org/overview/filings (last visited Oct. 4, 2004). *See also* Monitoring Report, CC Docket No. 98-202, (rel. Oct. 2001) at Table 3.27 (all statistics).

[12] *Rural Task Force White Paper #2* at 50.

[13] *Id.* at 54.

universal service fund eligibility rules or calculation of support that do not account for the massive reforms also under consideration at the FCC could have a devastating effect on rural communities. The Joint Board should make its recommendations to the FCC with the unique characteristics of rural areas in mind, and should not exacerbate the precarious regulatory environment already faced by rural carriers.

III. Rural Telephone Companies Should Continue to Receive Cost-Based Support at the Study Area Level

The Joint Board should reject proposals to penalize operating companies that are owned as part of a larger holding company structure by calculating a carrier's costs across an entire holding company or at a state-wide level. By averaging costs across an entire state or holding company, many rural areas would no longer be considered "high-cost" thus depriving numerous rural communities of universal service funding. The study area remains the proper level for calculating support.

Holding companies maintain multiple study areas within a given state for a variety of reasons. It is important to understand that ILEC study area boundaries were and are not chosen by the ILEC, but rather were fixed by the FCC in 1984 to guard against ILECs establishing high cost exchanges within existing study areas in order to maximize support. ITTA's members that operate multiple study areas within a particular state have grown largely as a result of merger and acquisition activity. In many cases the rural holding companies have acquired study areas and/or exchanges from non-rural ILECs selling off more rural high cost properties. The costs and operational characteristics of the acquired study areas often are different from those of pre-existing study areas. Local rates and intrastate access rates typically are required to be maintained at pre-acquisition levels. The Notice failed to address the interaction between study area consolidation and these and other state and federal policies.

Retaining existing study areas within a state following a merger or acquisition maintains the structure upon which the viability of the transaction was evaluated. Thus, there are no distortions resulting from the retention of separate study areas.

In contrast, adoption of a requirement to average costs across a company's study areas state-wide or holding company-wide would create pricing distortions in local rates. Any "averaging" approach to a cost recovery mechanism invariably creates implicit subsidies. Loss of support to rural areas would require carriers to raise rates in lower cost markets to subsidize rates in high-cost areas. This is in direct conflict with Section 245(e), which requires that support be explicit. The creation of implicit support also is not sustainable in a competitive market. Today, even rural carriers face substantial competition from a variety of providers. Carriers cannot afford to raise rates in relatively low-cost areas because of competitive pressures. The only practical option would be to raise rates to customers only in the highest-cost markets. As stated above, such cost increases could cause even basic services in those areas to become unaffordable, which clearly violates the universal service mandates of the Act.[14]

Further, adoption of any proposal to require aggregation of study areas within a state or to aggregate all study areas served by companies owned by a common holding company could create insurmountable challenges for numerous rural communities. The midsize companies alone stand to lose tens of millions of dollars in federal high-cost support each year if this proposal were to be adopted. Holding companies that, through their operating subsidiaries, serve both rural and urban areas would be encouraged to sell off urban exchanges to avoid a scenario where costs averaged across a study area would cause the holding company to be ineligible for support. The Joint Board should not recommend any proposal that would

[14] 47 U.S.C. § 254(b)(3).

encourage wholesale changes to corporate structures in order to minimize loss of universal service support. Such fractionalization of the industry would destroy economies of scale that cannot be matched by independent ILECs.

The current system fully captures the efficiencies of holding companies, by reducing their per-line support amounts across each study area and across multiple study areas. The existing methodology accurately captures each operating company's allowed costs, while limiting recovery of corporate overheads. Also limiting cost recovery, rural ILEC high-cost loop support is capped.[15] Moreover, the efficiencies achieved by holding companies are fully reflected in rural carriers' costs as reported for universal service purposes and drive down demands on the fund. In contrast, a system that encourages divestitures of lines to smaller companies would create new inefficiencies, driving up demand on the high-cost fund.

Aggregating costs statewide (or even nationwide) harms rural consumers, establishes inefficient, implicit subsidies and would fail to provide "specific" (targeted) support. The study area is the level at which costs are currently measured and cost/price distortions are minimized. Aggregating costs at a level higher than study area is not in the best interests of rural customers who depend on the support for access to a network of advanced telecommunications services. By contrast there is no benefit to establishing a high-cost universal service mechanism on a more granular level such as wire center. Embedded costs are not measured at the wire center level and imposing the administrative requirements associated with maintaining costs at this level would not increase the specificity or the precision of the support calculation. There is

[15] 47 C.F.R. §36.601(c).

currently an optional mechanism in place that allows a rural study area to disaggregate high-cost support should it prove necessary.[16]

IV. Adopting a Forward-Looking Cost Model Would Cause Significant Disruption In Rural Markets, With No Guarantee of Public Benefit

The current system of calculating rural high-cost universal service support was designed to ensure that support is tailored to the specific needs of the carrier-of-last-resort. Calculating rural universal service using actual embedded cost produces funding that is predictable and sufficient (or would be sufficient if not for the caps imposed by the FCC in recent years). The differences between rural and non-rural carriers make it problematic to apply the forward-looking high-cost support mechanism adopted for non-rural carriers to rural carriers.[17] The FCC has concluded in the past that the universal service support mechanisms for rural carriers should differ from those for non-rural carriers at least on an interim basis.[18] Citing the many differences between rural and non-rural carriers, the FCC *twice* has declined to adopt a forward-looking economic cost model for rural carriers.[19] The Joint Board should recommend that the FCC once again reject a movement away from embedded costs.[20]

---

[16] *See* Comments of the Independent Telephone and Telecommunications Alliance, CC Docket No. 9645, FCC 04J-2, at 21 (filed Oct. 15, 2004).

[17] *See Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Relating to High-Cost Universal Service Support*, Public Notice in CC Docket 96-45, FCC 04J-2, at ¶¶ 28-32 (rel. Aug. 16, 2004) ("Public Notice") (seeking comment on the application of the synthesis model to rural carriers).

[18] *Universal Service First Report and Order*, 12 FCC Rcd at 8934 (¶ 291).

[19] *Id.*; *In the Matter of Federal-State Joint Board on Universal Service, Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256, 16 FCC Rcd 11244, 11256 ¶25 (2001) ("*RTF Order*"), as corrected by *Errata*, CC Docket Nos. 96-45, 00-256 (Acc. Pol. Div. rel. Jun. 1, 2001), *recon. pending.*

[20] *See* Comments of the Regulatory Commission of Alaska, CC Docket No. 9645, FCC 04J-2, at 6-7 (filed Oct. 15, 2004) (demonstrating that a forward-looking cost model is inappropriate for rural areas).

Utilizing an embedded cost mechanism to determine universal service support is the most precise method for determining network cost recovery. Such a system depends on measurable, historic costs of a network that is in place and functioning, and provides a reliable account of the actual cost of deploying and operating rural networks.[21] It is a self-correcting mechanism in that cost changes are accounted for in the calculation of universal service support. Efficiencies resulting from economies of scale and scope, changes in technology and other operational economies are reflected in the calculation and result in a reduced cost per line and a correspondingly lessened dependency on high-cost support. Basing the calculation on actual costs also eliminates any potential for "gaming" of the high-cost universal service support system by over-estimating or under-estimating costs. A rural ILEC that under-invests in the network realizes a reduction in its support payments in direct relation to its reduced spending.

ITTA has good reason to be pessimistic about basing cost recovery on forward-looking costs. Establishing a methodology predicated on forward-looking costs is a task that has proven to be unwieldy, inaccurate and an enormous drain on FCC and state commission resources. The use of forward-looking proxy costs has been plagued by a lack of precision. Even after spending more than two years in developing a non-rural proxy model for the calculation of high cost universal service funding (the FCC's Hybrid Cost Proxy Model or Synthesis Model), the FCC did not believe that the model predicted loop costs in a specific and precise fashion. Instead the FCC used the costs produced by the Synthesis Model in a relative

[21] *See* Comments of the National Exchange Carrier Association, CC Docket No. 9645, FCC 04J-2, at 13 (filed Oct. 15, 2004).

fashion to distribute funds among states qualifying for non-rural high-cost universal service funds.[22]

While the task of developing a forward-looking cost proxy model has proven to be difficult with non-rural companies that are relatively homogenous, the task would be exponentially more difficult when attempting to model the costs of a population of widely variant rural carriers. In evaluating proxy models for use in calculating high-cost support for rural carriers, the RTF concluded in its White Paper #4[23] that because of the variability in results, adoption of a proxy model for determining rural high cost support would produce extremely large dislocations (including reductions as well as potential windfalls) in universal service support for rural customers. For this reason the RTF recommended a continued reliance on an embedded cost methodology. There has been no material change in circumstance since then to warrant adoption of proxies.

The Total Element Long Run Incremental Cost ("TELRIC") forward-looking cost model for unbundled network elements ("UNEs") has produced notoriously wide-ranging results, leading to a tortuous succession of workshops, hearings, briefings and arbitrations at the federal level and in states throughout the country. The Regulatory Commission of Alaska, which has significant experience with both rural carriers and forward-looking cost models, supports keeping rural companies on an embedded cost basis because a forward-looking model would not accurately predict costs in rural Alaska. Indeed, even in the non-rural city of Anchorage,

---

[22] *See generally Application by Verizon New England Inc., Verizon Delaware Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance, NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services in New Hampshire and Delaware*, 17 FCC Rcd 18660, 18689 (¶¶ 47-48) (2002) (explaining that the Commission developed an extensive record to support its conclusion that the Synthesis Model accurately reflects relative cost differences between states).

[23] *See generally* Rural Task Force, *A Review of the FCC's Non-Rural Universal Service Fund Method and the Synthesis Model for Rural Telephone Companies*, White Paper #4 (Sept. 2000) ("*Rural Task Force White Paper #4*").

depending on the "interpretation" of TELRIC, the predictable cost of a loop in ACS' Anchorage market has varied from $5 to $25.[24] It strains credulity that the Joint Board would even consider inflicting this forward-looking cost model morass on rural carriers, considering TELRIC's dubious track record. The Joint Board should therefore recommend that the FCC continue to calculate costs on a rural carrier's embedded costs, rather than developing a forward-looking cost model for rural universal service.

[24] *See* Comments of ACS of Alaska, Inc., ACS of Fairbanks, Inc., ACS of the Northland, Inc. and ACS of Anchorage, Inc., CC Docket No. 9645, FCC 04J-2, at 12 (filed Oct. 15, 2004).

V. Conclusion

ITTA urges the Joint Board to move cautiously when recommending changes to the current universal service support mechanism for rural carriers. The current rural high-cost support mechanism is not "broken." The statutory definition of "rural telephone company" properly identifies those carriers eligible for rural universal service support. Similarly, there is no need to "average" costs at the state or national level – funding requirements do not vary as a function of corporate parentage. Further, there is no evidence that a forward-looking cost approach would be appropriate for or ultimately effective in for determining rural high cost support. Actual embedded costs continue to be the proper method for establishing universal service support that is "specific, predictable and sufficient" and ensures continued access to advanced services through a modern telephone network for customers in rural markets.

Prepared this 9th day of November, 2004

/s/

Jeffrey Reynolds
Principal
Parrish, Blessing & Associates, Inc.

On Behalf of

INDEPENDENT TELEPHONE AND
TELECOMMUNICATIONS ALLIANCE
1300 Connecticut Avenue, N.W., Suite 600
Washington, DC 20036
(202) 775-8116